

# CONTRACTOR

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## No construction company is safe

Fraud continues to impede  
projects, threaten profits



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Certified Public Accountants & Business Consultants

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*Not The Same Old Bottom Line*

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# No construction company is safe

## Fraud continues to impede projects, threaten profits

**C**ompared to the risks construction companies face every day on their jobs, fraud may seem a relatively small danger. It isn't. Construction companies that are victims of fraud experience a median loss of \$330,000, according to the Association of Certified Fraud Examiners (ACFE).

In its 2008 *Report to the Nation*, the ACFE noted that, though the construction industry reports fewer cases of fraud than many other industries, the losses per occurrence are fifth highest among industries surveyed. In other words, even a single incident of fraud could undermine all (or much) of your hard work over the past year.

### 3 "hot" frauds to watch for

So what types of fraud are hot right now? Three in particular to watch for are:

**1. Scrap metal scams.** Scrap metal is a valuable commodity, especially during periods of economic uncertainty. You may keep a close watch on what leaves your job sites, but do you watch what comes in?



Acting in collusion with an accomplice in the scrap or junkyard business, an unscrupulous employee can order more metal (copper is particularly in demand) than you need, hide the cost in job reports and sell the excess to the accomplice for cash.

To prevent this type of fraud, make sure no one person is responsible for both ordering materials and approving their costs. Additionally, someone other than the person who orders materials should check them in when they arrive at job sites.

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**2. Misbegotten mechanics.** Another fraud that requires collaborative effort is that of false equipment repairs. In this scam, an outside mechanic submits phony maintenance and repair invoices. An employee then approves them and splits the resultant payment with the mechanic.

Again, oversight is the key to preventing such schemes. Someone other than the employee who approves maintenance costs should review invoices. If a cost seems off-base, the reviewer should check with equipment operators to see when — or whether — the work was done.

**3. "Dead" vendors.** In this scam, someone sends you invoices bearing the logo and letterhead of a company that's closing because the owner has very recently died or retired or the company is no longer operating. Before you're aware the company is "dead," you've paid the bogus charges and the fraudster is off to another scam.

To prevent this one, pay close attention to the invoices that come in, and make sure you're paying for something you actually ordered.

### Proactive measures

In addition to these frauds, construction companies are subject to the same billing, payroll, vendor and customer frauds that all businesses must guard against. To protect yourself, be proactive.

Establish internal controls that make it difficult for fraudsters to succeed, and adopt a "zero-tolerance"

policy toward any type of unethical behavior. Make background checks a routine part of your hiring procedures, and incorporate the basics of fraud deterrence in your employee training programs. (Your CPA can coach you on exactly what these basics are.)

The ACFE has also reported that tips are the most common way frauds are discovered. So invest in a third-party tipline and make sure all workers know their responsibility in reporting suspicious behavior.

Beyond that, work with your site supervisors, financial advisor and office administrators to identify and address weaknesses in your

operations that could lead to fraud. If the same person who pays the bills also approves purchase orders and reconciles the accounts, for example, it would be easy for that person to write fraudulent checks undetected. Assign the job of reconciling the accounts to someone else, and fraud becomes much more difficult.

#### **An unwelcome guest**

Fraud is here to stay, but there's no need for you to make it anything other than an unwelcome guest. Accepting that fraud can affect any business is the first step to preventing it. The second is putting safeguards in place to protect against it. ■

## Going, going, gone . . .

### **Catch profit fade before it lowers the curtain on your bottom line**

It's an all-too-familiar story: XYZ Construction had a job that wouldn't end. The contract was nearly complete, but the costs kept accruing as last-minute changes added up. By the time the work was finished, any hope of a profit was finished, too.

The fictitious XYZ fell victim to a very real, and potentially disabling, financial predicament called "profit fade." It occurs when a job fails to go as planned, and your carefully estimated profit margin shrinks to nothing — or less.

In an industry that isn't known for high profit margins to begin with, profit fade can be a deadly threat. Fortunately, there are ways to catch it.

#### **Know your enemy**

As every contractor knows, the profit you calculate when bidding a job can fluctuate dramatically as work progresses. For every phase you finish under budget, there's an unexpected problem waiting to wipe out the savings. If you want to end at the top of the arc, you need to stay on top of each project's swings.

Every significant cost increase should be accompanied by a change order that increases the value of the contract. If it isn't, determine why. Was your initial estimate off? Or have you done extra work that wasn't covered by a change order?



## Why sureties care about profit fade

Protecting your company from profit fade (see main article) can protect your bonding capacity as well. Sureties get nervous when you don't make as much money as you expect, so review your projection methods regularly to ensure you're getting the best possible results.

In addition, you may want to hold off adjusting costs until the job is well over half complete. You may, for example, score a great deal on concrete early in the project, but your savings could easily be offset by a later increase in fuel or labor costs. Don't change your original estimates until you know for sure.

Last, sureties look at your billing practices. If you're billing some projects early to compensate for profit fade on others, your standing could go down.

Above all, sureties value honest, consistent information. Don't do anything that might imply — even slightly — that you're being dishonest.

In either case, you're headed for profit fade, and you should find ways to get the job back on revenue-friendly status.

### Watch your back

In addition to monitoring works in progress, study your estimating and profit histories. Review some good jobs and some that didn't work out so well to determine where the jobs didn't meet budgets and whether expenses were allocated properly.

Discuss with your job supervisors whether the assumptions you used in estimating the projects were valid. Did you, for example, realistically calculate the number of bricks your crews could lay in a day? Were your average labor costs accurate?

Also consider direct and indirect costs, and compare your estimates on jobs that lost money to those you used on profitable projects. Then use the results to improve your estimating procedures on future projects. If, for example, projects were delayed because you expected your project manager to obtain final foundation design approvals and shop drawings while also getting the job under way, you may need to revisit your staffing estimates.

Look, too, at whether certain owners cost you money. If one owner consistently moved walls or added doors, you may want to be sure any future contracts with that owner include very specific language regarding scope and

specification changes, change orders and schedule revisions.

### Perform as planned

Before work begins, understand fully what you've contracted to do. Contract language is often unclear, resulting in differences in interpretations that can disrupt and delay projects. A careful review of your contracts at the start and the subsequent clarifications that are needed can help prevent disruption and delay.

Also make sure your project managers understand the contract language fully. Meet with them before every project to discuss not only the contractual provisions for scope of work and change orders, but also what you bid and why. If your managers don't know how much you allocated for materials, and how you arrived at that number, they can't reasonably be expected to meet your budget.

As work progresses, meet with your project managers regularly to make sure they are comparing their actual costs to the bid cost amounts. If a problem arises, they can address it immediately. They should also note the reason for the issue. If you're typically plagued by weather delays during a certain time of year, you may need to build a little more time into your bids. If a supplier or subcontractor is always late, you may need to find other sources for those materials or services.

If there's a problem, remember that your leverage is strongest before the project is finished. Owners need your help to meet their goals, and they may be more amenable to approving change orders while you're still on the job. If you wait until the project is done, remember: Owners have use of the facility and may not have released your retainage. In other words, they're holding all the cards.

### Plan to succeed

It's a rare construction project that goes as planned from start to finish. But, if your profit routinely runs out before you've completed the final punch list, you have a problem.

To keep profits on a solid footing, constantly review your practices and procedures in order to identify any weaknesses and correct them immediately. You can't predict every problem, but you don't have to let profit fade lower the curtain on your bottom line, either. ■

# Don't let aggressive drivers wreck your safety record

If you have more than one job site going at a time, chances are you have employees driving between them. Do you know whether they're driving safely? If you don't, your construction company's safety record may be living on borrowed time.

## Aggression breeds accidents

Highway crashes caused half the transportation-related job fatalities in the nation's construction industry in 2006, according to the U.S. Department of Labor's Bureau of Labor Statistics. And the National Highway Traffic Safety Administration reported that 50% of all those traffic fatalities were caused by drivers who were speeding or failed to stay in their own lanes.

In other words, half of the traffic fatalities in 2006 were caused by aggressive drivers — those who speed, tailgate, weave in and out of traffic, pass on the right or otherwise put themselves and others at risk. They also put your bottom line at risk, which is why more contractors are adding traffic safety components to their overall safety programs.

Safety aside, if any of your employees are guilty of aggressive driving by routinely slamming on the brakes or stomping on the gas pedal, they're undoubtedly adding to your maintenance and fuel costs. More important, their driving could create liability for you if they hit someone's property or damage some of your work in progress.

## Education is key

Fine, you say, but what can I do about it? The first thing you can do, according to the Occupational Safety and Health Administration (OSHA), is develop written traffic safety policies. In addition to emphasizing the importance of wearing seatbelts and prohibiting drugs and alcohol during work hours, let your employees know what you believe constitutes aggressive driving and what you're going to do about it if you find out your employees are engaged in it.

Some signs of road rage are obvious: obscene gestures, refusing to allow someone to pass, racing to beat a yellow light. Others aren't: for example, getting angry at someone who's talking on a cell phone or putting on makeup.

Tell employees your company will have to bear the cost of accidents that occur both on and off the job, and ask them to sign agreements stating that they won't engage in aggressive driving behaviors. Signing such an agreement forces workers to at least consider their driving habits and acknowledge that they understand your policies.

If an accident does happen, insist that those involved report it immediately. Whether a worker backs a pickup truck into someone's mailbox or clips a fascia with the bucket of a backhoe, require him or her to notify the appropriate supervisor immediately.

Meanwhile, check with your attorney and develop a progressive disciplinary policy to address drivers who have multiple incidents of preventable crashes, as well as a reward policy for safe driving performance.

## A good habit

You can't be with your employees every time they get behind the wheel, but you can make safe driving an integral part of your corporate policy. It's a good habit to promote among your staff — and a good way to protect your bottom line. ■



# New technology helps contractors manage weather-related risk

**L**et's face it, you're at the mercy of Mother Nature. Whether battling ice storms in New England, drought on the West Coast or thunderstorms in the Midwest, weather can wreak havoc on any contractor's project schedule.

Fortunately, technology can now help you weather the storms without getting soaked. Software developers have created "weather risk management solutions" specifically for contractors to help mitigate the weather's effects on their jobs.

## Forecasting the inevitable

Construction is so closely linked to weather that many contracts specify the conditions that constitute acceptable reasons for delay. Yet, often, only weather deemed unusually severe or unforeseeable, as in the case of a tornado or prolonged flooding, qualifies as "acceptable." The rest of the time, you'd better build some weather delays into your schedule from the start.

Even then, you may not recover all that weather delays cost you. You may win an extension on your contractual completion date, but, in the construction business, time may literally

be money. If you've financed a project with a bank loan, for instance, the interest doesn't stop accruing because you've stopped work. And if the rain keeps coming, you may be forced to defend extended delays in court.

Indices now allow you to quantify the type of weather most likely to affect your projects and then manage the risk in stock market terms.

In the last few years, however, companies such as MSI GuaranteedWeather ([guaranteedweather.com](http://guaranteedweather.com)) and Storm Risk Solutions ([stormexchange.com](http://stormexchange.com)) have begun offering indices that allow you to quantify the type of weather most likely to affect your projects in financial terms. Then you can manage the risk in stock market terms.

## Hedging your bets

When you know, for example, that a certain location typically sees 10 days of rain in June, with an average total precipitation of 2 inches, you can more accurately gauge the time you might lose during site preparation, framing or other weather-dependent job phases.



You can also decide how to hedge with insurance coverage. Weather prediction being the uncertain science that it is, deciding on coverage is still something of a gamble. But if your biggest weather risk is an extra-rainy summer building season, you may want “call” option coverage that will pay you a specified amount if rainfall totals more than a certain number of inches.

Your coverage will depend on your specific circumstances but, as an example, say you get \$100,000 for every half-inch of rain over the two-inch average in June. (In this case, two inches is the “strike,” or the “trigger,” point.) If it rains four inches in June, you’d receive \$400,000. With a “put” option, you pay if weather doesn’t happen.

Continuing the example above, let’s say the put strike is an inch of rain in June. If it rains an inch,

you might pay the carrier, say, \$200,000, or \$100,000 for each half-inch under the two-inch strike. The advantage to you is that the \$200,000 is probably less than the extra revenue you’d see from a drier-than-normal summer month.

Or you may choose to cover both ends with a “collar” option, which includes provisions for both excessive weather and unusual weather deficits. You get paid if it rains four inches, and you pay if it rains only an inch.

### Exploring the concept

As you can see, using weather risk management software to handle your insurance costs is a bit of a gamble. And, understandably, not every contractor is comfortable with the perils and demands of this approach. Nonetheless, it’s a concept worth exploring. ■



## Construction Success Story

### Contractor builds Web site to sell spec houses

A residential contractor with several spec houses on the market was concerned that her homes weren’t getting the attention they deserved, despite the number of unique and desirable features she had built in. She discussed the problem with her financial advisor, and the two agreed that a Web site might add visibility and help build profits.

Just having a presence on the Internet would set her apart from the competition, according to a 2007 study by the Small Business Research Board. That study found that 57% of construction businesses don’t have Web sites — the lowest Internet participation percentage of any industry.

As the accountant noted, a Web site could help the contractor in a number of ways. The most obvious would be to introduce the company and its products to a wider audience. By building the site with search engine optimization (SEO) in mind, the contractor could help ensure that her company was closer to the top of the list on Google or Yahoo! search results. And with digital pictures of the houses’ interiors and exteriors, the contractor could showcase the features and benefits most likely to appeal to prospective buyers.

Additionally, a Web site could be a fast, cost-effective way to educate potential customers about her company and its capabilities. The mere existence of a Web site would suggest stability and reputability, while a company history, customer testimonials, and statistics and photos of previous jobs would add status without a great deal of cost.

To be successful, however, she realized the Web site had to be different. She worked with professional Web designers and writers to craft a site that was easy for visitors to navigate and designed for SEO.

Within six months of the site “going live,” she had shown her spec houses to 15 potential buyers who found her online. The profit she made on just one of the sales was more than enough to pay for the Web site — and to make her a firm believer in the value of listening to her accountant.

# The expertise you need, the service you want.

**A**t Smith & Gesteland, LLP we know that running a successful construction company these days requires more than just dedication and hard work. It takes the assistance of experts who understand the industry and the challenges contractors face, and who have the specialized knowledge, hands-on experience and service commitment it takes to help them achieve their business goals.

Our Construction Industry Services Group consists of experienced professionals focused on increasing the success of companies like yours. For more than 50 years, our firm has served individuals and businesses throughout south central Wisconsin. We are delighted to currently work with more than 100 contractors and to have recently been voted Madison's Number 1 accounting firm. We are ready to assist you with a broad range of services tailored specifically to your needs, including:

- Profitability improvement
- Cash flow projections
- Quality and productivity enhancement
- Estimating/bidding improvement
- Bonding capacity maximization
- Lease vs. purchase analyses
- Tax reduction strategies
- Business valuations
- Succession and estate planning
- Financing assistance / growth management
- Project management and accounting systems
- Litigation and claims support

As specialists in the construction industry, Smith & Gesteland has developed the expertise needed to help contractors address and meet their many challenges. We would welcome the opportunity to help you build your success.

To find out what we can do for you, or for more information about the ideas presented in this newsletter, please contact John Folsom or Steve Pullara at (608) 836-7500 or [mail@sgcpa.com](mailto:mail@sgcpa.com). We look forward to talking with you.

**Smith & Gesteland**<sup>LLP</sup>

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